In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 838

CHARTER WIRE, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact, discussion, and conclusions of law of the district court (R. 147–161) [1] are not officially reported. The opinion of the court of appeals (Pet. 21–27) is reported at 309 F. 2d 878.

JURISDICTION

The judgment of the court of appeals was entered on November 28, 1962 (Pet. 28). The petition for writ of certiorari was filed on February 16, 1963. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

[1] "R." references are to the appendix to the petitioner's brief in the court of appeals.

QUESTION PRESENTED

Whether, on the facts of this case, the courts below correctly held that certain payments by the taxpayer-corporation to its stockholders were not payments of interest on indebtedness within the meaning of Section 23(b) of the Internal Revenue Code of 1939 and Section 163(a) of the Internal Revenue Code of 1954, but non-deductible dividend distributions.

STATEMENT

The taxpayer is a Wisconsin corporation engaged in the business of drawing and rolling wire. It was formed in 1946 to take over the assets and business of a partnership composed of three individuals. In exchange for the assets of the partnership, each of the partners received a portion of $66,805.74 in promissory notes (representing the book value of the transferred assets). In exchange for a total of $680, each partner received the same percentage of the corporation's stock as the amount of the notes that partner received bore to the total of the notes distributed. The former partners became directors and officers of the new corporation and remained directors and officers through the years in question. The parties maintained proportionate holdings of stock and notes. (R. 148–151; Pet. 22–23.)

From March 1947 to March 1954 the stockholders subordinated their notes to obligations arising from corporate bank borrowings. Interest was paid regularly on the notes, except that in 1947, in order to meet taxpayer's trade obligations and because of a desire to maintain its record of discounting bills, the directors

voted to suspend payments of such interest, which were in fact suspended for a three-month period. (R. 151–153; Pet. 23–24.)

In 1953, taxpayer negotiated for the hiring of J. Willard Marshall for an executive position. Marshall was interested in coming with the taxpayer only if he were allowed to buy an interest in it. He was allowed to buy stock, and, after a suggestion that he make a loan to the corporation, he did so and received a note in an amount which bore the same ratio to the total amount of all the notes outstanding as his share of voting stock bore to the total voting stock then issued. (R. 154–155; Pet. 24.)

In 1954, the outstanding notes, which had a maturity date of January 31, 1956, were replaced by a new issue of notes with a maturity date of January 31, 1960, and which contained new and different terms (R. 155–156; Pet. 24).

During the years 1952, 1953, 1954, and 1955, the taxpayer paid to the shareholder-noteholders a total of $15,489.38 and deducted the payments as interest on its tax returns (R. 148). The Commissioner's determination that the payments represented dividend distributions rather than interest was sustained by the district court (R. 158–161), and the court of appeals affirmed (Pet. 21–28).

ARGUMENT

The decision of the court below is correct and is not in conflict with any other decision. It affirms the district court's finding that certain transfers of assets and money made to the taxpayer-corporation

by its shareholders in exchange for corporate notes were capital investments rather than loans, and that purported interest payments made by the corporation to the shareholders in fact represented nondeductible dividend distributions.

In so holding, the court below applied the principles established by this Court in *John Kelley Co.* v. *Commissioner* (decided with *Talbot Mills* v. *Commissioner*), 326 U.S. 521, that the question whether an advance by a stockholder to a corporation represents a loan or a capital contribution is essentially one of fact (326 U.S. at 526) and that "[t]here is no one characteristic, not even exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts" (326 U.S. at 530). See also *P. M. Finance Corp.* v. *Commissioner*, 302 F. 2d 786 (C.A. 3); *Brake & Electric Sales Corp.* v. *United States*, 287 F. 426 (C.A. 1); *O. H. Kruse Grain & Milling* v. *Commissioner*, 279 F. 2d 123, 125–126 (C.A. 9); *Gilbert* v. *Commissioner*, 248 F. 2d 399, 406–407, and 262 F. 2d 512, 513–514 (C.A. 2), certiorari denied, 359 U.S. 1002; *Gregg Co. of Delaware* v. *Commissioner*, 239 F. 2d 498, 501–502 (C.A. 2), certiorari denied, 353 U.S. 946; *Rowan* v. *United States*, 219 F. 2d 51, 55 (C.A. 5); *Arlington Park Jockey Club* v. *Sauber*, 262 F. 2d 902, 905 (C.A. 7); *Commissioner* v. *Meridian & Thirteenth R. Co.*, 132 F. 2d 182, 185 (C.A. 7); Note, *Thin Capitalization and Tax Avoidance*, 55 Columbia L. Rev. 1054 (1955); Goldstein, *Corporate Indebtedness to Shareholders: "Thin*

Capitalization" and Related Problems, 16 Tax L. Rev. 1 (1960); Hellerstein, *Planning the Corporation*, Seventh Annual Tulane Tax Institute 416, 429 *et seq.* (1958). The form of the purported loan transaction is not determinative of the question, and the taxpayer has the burden of proving by a preponderance of the evidence that the advances were not risk investments. *John Kelley Co.* v. *Commissioner*, *supra*, 326 U.S. at 530; *P. M. Finance Corp.* v. *Commissioner*, *supra*, 302 F. 2d at 789; *O. H. Kruse Grain & Milling* v. *Commissioner*, *supra*, 279 F. 2d at 125; *Arlington Park Jockey Club* v. *Sauber*, *supra*, 262 F. 2d at 905; *Gregg Co. of Delaware* v. *Commissioner*, *supra*, 239 F. 2d at 502; *Gilbert* v. *Commissioner*, 262 F. 2d 512, 513 (C.A. 2), certiorari denied, 359 U.S. 1002; *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159, 166 (C.A. 6), certiorari denied, 352 U.S. 1031; *Matthiessen* v. *Commissioner*, 194 F. 2d 659, 661 (C.A. 2); *Schnitzer* v. *Commissioner*, 13 T.C. 43, 60, affirmed *per curiam*, 183 F. 2d 70 (C.A. 9), certiorari denied, 340 U.S. 911.

The evidence recited in detail by both courts below warrants the district court's conclusion that the "notes" issued by the taxpayer-corporation to its shareholders evidenced an equity interest rather than a genuine creditor interest and consequently that the "interest" paid to the stockholders represented non-deductible returns on a capital investment. The original notes were received by the stockholder officers for all the physical assets of their prior partnership transferred to the corporation. Notes were held proportionately to stockholdings and proportion-

ate holding of stock and notes was carefully maintained when J. W. Marshall was allowed to purchase an equity interest in the corporation. The stockholders disregarded the terms of the notes when their interests as stockholders and officers could otherwise best be served. Thus, interest was deferred in 1947 when the corporation was short of cash; the noteholders subordinated their notes to bank loans; and, when the corporation was engaged in improving and expanding its operations, the maturity date was extended, a provision for automatic maturity on the death of the holder was removed, and the interest rate was lowered. The dealings with J. W. Marshall, culminating in his purchase of stock and a note, clearly reflect that the stockholders considered the contributions represented by their notes as part of the equity capital of the corporation. The holding of the court below (Pet. 21–27) that the totality of the facts indicates a risk-capital investment is clearly correct.

Taxpayer's argument that certain formal criteria should be adopted to determine when an instrument is a debt obligation (Pet. 12–15) should be addressed to Congress, not to this Court. Indeed, as taxpayer notes, proposals for such legislation have been suggested, but until such time as Congress sees fit to change the law, the decision as to whether advances to a corporation are in substance capital contributions or loans depends upon all the facts in the particular case, no one of them being determinative. Since determination of the question depends upon

the particular record made before the trial court, the taxpayer's suggestions of conflict are plainly without merit.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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